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No. 86-751

In the Supreme Court of the United States

OCTOBER TERM, 1986

ARKANSAS BEST CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT

CHARLES FRIED
Solicitor General

ROGER M. OLSEN
Assistant Attorney General

ERNEST J. BROWN
Attorney

Department of Justice
Washington, D.C. 20530
(202) 633-2217

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QUESTION PRESENTED

Whether 661,000 shares of common stock of a bank that petitioner sold in 1975 were "capital assets" as defined in Section 1221 of the Internal Revenue Code, with the result that the loss realized by petitioner on the sale of the stock was not an ordinary loss, but rather was a capital loss subject to limited deductibility under Section 165(f) of the Code.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A12) is reported at 800 F.2d 215. The opinion of the Tax Court (Pet. App. B1-B28) is reported at 83 T.C. 640.

JURISDICTION

The judgment of the court of appeals was entered on September 9, 1986. The petition for a writ of certiorari was filed on November 7, 1986. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner is a diversified holding company. It was organized in 1966 to hold all of the stock of Arkansas Best Freight System, Inc., a successful trucking line operating in the Midwest. Petitioner immediately embarked upon a program of becoming a conglomerate. It acquired all of the stock of various corporations engaged in furniture manufacturing, insurance, data processing, used tire retreading, and new tire sales. The tire subsidiary also held

the real estate occupied by petitioner and its subsidiaries. Petitioner provided financial planning and, in some cases, accounting and personnel services to its subsidiaries, and they in turn paid a management fee to petitioner. The group of companies interacted with each other in a synergistic fashion. Pet. App. A2, B3-B4, B19.

Management and control of petitioner rested with its Chairman of the Board, Robert A. Young, Jr., and with members of his family, until Young's death in 1973. During the period from March 1967 to April 1968, Young personally acquired 209,000 shares of the common stock of the National Bank of Commerce of Dallas, Texas (the Bank), as well as rights to buy additional Bank shares. These shares and rights were transferred to petitioner in June 1968. As a result of these transactions, and of petitioner's purchase of additional Bank shares later that year, petitioner at the end of 1968 owned 266,614 shares of the Bank's common stock, or 64.97% of the then-outstanding common shares. Pet. App. A2, B4-B5.

At the time petitioner acquired the Bank shares, it was aware of pending congressional legislation concerning bank holding companies that, if enacted, would substantially affect corporations that acquired controlling interests in banks. Petitioner had called a special meeting of its shareholders to consider the proposed acquisition of Bank stock, and it had informed them in a proxy statement that the pending legislation, if enacted, would classify petitioner as a bank holding company if it acquired the Bank shares, and might require it, as such, to divest itself of companies that were not banks. On the other hand, petitioner had obtained disinterested appraisals of the Bank stock and projections of the Bank's expected growth and earnings, which indicated that there were a number of reasons for acquiring an equity investment in the Bank. Dallas at the time was developing rapidly as a financial center, and banks were at the center of the

boom, so that it appeared likely that the value of the Bank shares would appreciate. Moreover, petitioner was planning a public offering of its own shares and believed that its financial statements would be rendered more attractive by virtue of owning the Bank stock. The acquisition was also expected to yield favorable results in other respects, including improved price/earnings ratios, enhanced prestige and access to financing in the financial community, and some protection from hostile takeover attempts. Pet. App. B5-B6.

After the acquisition, the Bank did not interact with petitioner and its subsidiaries in the same synergistic fashion as the other subsidiaries. The Bank offered no financing to the corporate group and, as was typical of banks, it contributed little by way of earnings distributions. Petitioner supplied no management services to the Bank, and the Bank did not pay it any management fees. At no time did petitioner have more than three representatives on the Bank's board of directors, which averaged 20 members. Pet. App. B7.

In December 1970, Congress enacted the Bank Holding Company Act Amendments of 1970, Pub. L. No. 91-607, 84 Stat. 1760 *et seq.* Pursuant to this new statute, petitioner was classified as a bank holding company and was required either to cease making acquisitions of non-bank businesses or to divest itself of its interest in the Bank. Petitioner chose the latter alternative. On July 30, 1971, petitioner filed with the Federal Reserve Bank of Dallas an irrevocable declaration that it would divest itself of its interest in the Bank within nine and one-half years, that is, prior to January 1, 1981. Petitioner was then free to make further acquisitions of non-bank businesses, and it proceeded to do so. Pet. App. B7.

Between 1969 and 1974, petitioner acquired additional Bank shares by means of various purchases, stock dividends, conversions, and responses to capital calls, all

of which served to increase petitioner's ownership interest only slightly, to 65.77%. Pet. App. B8-B9.[1] The capital calls made by the Bank during this period reflected the concerns of federal regulators that the Bank was inadequately capitalized. From 1968 until 1972 the bank appeared to be successful and growing, and the capital calls were initially designed to accommodate that growth. In 1972, however, after petitioner had commenced negotiations with Texas Commerce Bancshares (TCB) to divest itself of the Bank stock on favorable terms, TCB's representatives examined the Bank's loan portfolio and discovered serious problems. The negotiations were thereupon terminated. Subsequently, federal examiners undertook their own examination and classified the Bank as a problem bank, primarily because it had a heavy concentration of loans in the Dallas real estate business, which suffered a severe collapse at about that time. Pet. App. A2-A3, B9.

The capital calls issued by the Bank after 1972 were in response to these loan-portfolio problems. Petitioner responded to the post-1972 capital calls for a number of reasons. First, participation of the majority shareholder was essential to save the Bank, and thus petitioner was compelled to participate if it wished to preserve its equity stake. Second, failure to participate, with the resultant demise of the Bank, likely would have exposed petitioner to litigation by minority shareholders. Third, permitting the Bank to fail would reflect badly on petitioner so that

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[1] Some of the listed transactions that the Tax Court referred to as capital calls were referred to in a stipulation of facts submitted by the parties as exercises of stockholder pre-emptive rights (Stip. ¶ 20). Presumably, when added capital was required, shares were offered to existing shareholders on a prorata basis. Presumably, also, the stock dividends served the purpose of increasing capital by capitalizing earnings. That would explain why, although petitioner more than tripled the number of shares that it owned during this period, its percentage ownership increased only from 64.97% to 65.77%.

its sources of financing might be jeopardized and its reputation for skilled management might be tarnished. Pet. App. B10-B11.[2]

Notwithstanding the Bank's problems, petitioner still hoped, at least as late as July 1974, to dispose of its Bank stock at a profit, and it apparently expected capital gain treatment on such a disposition. At a meeting of petitioner's board of directors in that month, its general counsel reviewed the possible tax treatment of a bank stock divestiture. He expressed the hope that the anticipated capital gain could be spread over a ten-year period, or, alternatively, that the proceeds of sale could be invested in a new asset and that taxation of the capital gain could be delayed until the disposition of the new asset (Pet. App. B10). Throughout the period in question, petitioner carried the bank stock in its financial records as an investment (*id.* at B7).

On June 30, 1975, petitioner sold to a group of investors 661,000 shares of Bank stock, representing 51% of the outstanding common stock. That left petitioner with a 14.7% stake. For the 661,000 shares sold, petitioner received cash and other consideration with an aggregate value in excess of $5 million (Pet. App. B11). It was stipulated that petitioner's basis in the 661,000 shares was about $15 million (Stip. ¶ 7).

On a consolidated federal income tax return filed on behalf of itself and its subsidiaries for 1975, petitioner claimed a deduction for an ordinary loss in the amount of $9,995,688 from the sale of the 661,000 shares of Bank stock. In his notice of deficiencies, the Commissioner disallowed the claimed ordinary loss deduction, finding

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[2] The existence of these separately stated reasons was a finding of fact made by the Tax Court (Pet. App. B10-B11). In its opinion, however, the Tax Court made the somewhat contradictory statement that the post-1972 acquisitions were "solely to preserve [petitioner's] business reputation" (*id.* at B21).

that the loss resulting from the sale was a capital loss, subject to the limitations of Sections 165(f) and 1211(a) of the Internal Revenue Code.[3] Those sections generally provide that a corporate taxpayer may deduct capital losses only to the extent of its capital gains, while permitting excess capital losses to be carried over to other years.

2. Petitioner sought redetermination of the deficiencies in the Tax Court. The Tax Court agreed with the Commissioner that the Bank shares acquired before the end of 1972 were capital assets whose disposition gave rise to a capital loss. But the court held that most of the Bank shares acquired after 1972 were non-capital assets whose disposition gave rise to an ordinary loss. In so holding, the Tax Court accepted as its point of departure the Court of Claims' opinion in *Booth Newspapers, Inc.* v. *United States,* 303 F.2d 916 (1962). That decision and various cases following it had interpreted this Court's opinion in *Corn Products Refining Co.* v. *Commissioner,* 350 U.S. 46 (1955), to support the conclusion that securities disposed of by a business should be treated as a non-capital asset if they were purchased and held "as an integral and necessary act in the conduct of that business [rather than] purchased and held with an investment purpose." Pet. App. B16.

Extending the rationale of this so-called "*Corn Products* doctrine" to the facts here, the Tax Court stated that petitioner's acquisitions of Bank shares after 1972 were designed "to preserve [petitioner's] business reputation" and that expenditures for that purpose are typically deductible as business expenses (Pet. App. B20-B21). The court accordingly found that petitioner's post-1972 acquisitions of shares were "motivated by business purposes" (*id.*

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[3] Unless otherwise noted, all statutory references are to the Internal Revenue Code (26 U.S.C.), as amended (the Code or I.R.C.).

at B21) and from that premise concluded that the loss suffered upon the disposition of those shares in 1975 was an ordinary loss (*id.* at B20-B21). With respect to petitioner's acquisitions of Bank stock during 1968-1972, by contrast, the Tax Court concluded that the acquisitions "were motivated primarily by investment purpose" (*id.* at B18) and hence that the disposition of those shares in 1975 gave rise to capital losses (*id.* at B18-B19).

3. The Commissioner appealed with respect to the Tax Court's determination that some of the Bank shares sold in 1975 were non-capital assets. Petitioner cross-appealed with respect to the Tax Court's determination that certain shares were capital assets. The court of appeals, by a 2-1 vote, held in favor of the Commissioner, reversing "insofar as the Tax Court allowed ordinary loss treatment for any of the capital stock transactions" (Pet. App. A2), but affirming the Tax Court's decision in all other respects (*id.* at A1-A11).

The court of appeals concluded that none of petitioner's shares of Bank common stock fell within the definition of "capital asset" set forth in Section 1221 of the Code. That section generally defines a "capital asset" as "property held by the taxpayer (whether or not connected with his trade or business)," with five specific exceptions. The court concluded that the Bank shares satisfied the general definition in Section 1221 and, as petitioner conceded, that the shares did not fall within any of these specific statutory exceptions. Pet. App. A4-A8. The court of appeals acknowledged that some courts had "taken the position that capital stock is not a capital asset when acquired to assure a supply of raw materials vital to the taxpayer's business, to preserve an existing business, or even to pursue new business" (*id.* at A8 (citing cases)). But the court expressly rejected these decisions, characterizing them as "misbegotten" (*id.* at A10) and noting that they "lack a basis in the statutory language" (*id.* at A9).

The court of appeals specifically addressed the Fifth Circuit's recent decision in *Campbell Taggart, Inc.* v. *United States,* 744 F.2d 442 (1984), which it found to be "[t]he case most closely analogous to the case before [it]" (Pet. App. A9). That case, like this one, involved a holding company's purchase and sale of shares of stock in another company consummated in order to protect the holding company's "good will and reputation" (*ibid.*). The court of appeals below stated that it "d[id] not agree with the Fifth Circuit's interpretation of section 1221" in *Campbell Taggart,* which allowed the taxpayer there to take an ordinary loss on the sale of the shares in question (Pet. App. A10). To the contrary, the court below emphasized that it "d[id] not read *Corn Products* as either requiring or permitting the courts to decide that capital stock can be anything other than a capital asset under section 1221" (*ibid.*).[4]

DISCUSSION

Petitioner contends that the court of appeals erred in holding that its shares of stock in the Bank were "capital assets" whose disposition gave rise to a capital, rather than an ordinary, loss. We disagree with this contention. In our view, Section 1221 of the Code clearly provides that capital stock not falling within one of the statute's specific exceptions must be considered a capital asset, and the court of appeals' conclusion to this effect is fully consistent with the decisions of this Court. We do agree with petitioner, however, that the courts of appeals are in disarray on this issue and that the decision below directly conflicts with decisions in other circuits. Because this is an

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[4] In this regard, the court of appeals was not speaking of securities held as inventory by a securities dealer, which would be excluded from the definition of a "capital asset" under the exception for "inventory" set forth in Section 1221(1). See 2 B. Bittker, *Federal Taxation of Income, Estates, and Gifts* § 51.2.2, at 51-8 to 51-12 (1981).

important and recurring question, we accordingly do not oppose a grant of certiorari in this case.

1. The statutory framework that governs this case is unambiguous. Section 165(a) of the Code allows as a deduction "any loss sustained during the taxable year not compensated for by insurance or otherwise." That general rule is qualified by other subsections, including Section 165(f), which provides that "[l]osses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212." And Section 1211(a) of the Code provides: "In the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges."[5]

The question presented here thus turns on the meaning of the phrase "capital assets." Section 1221 provides the statutory definition: "For purposes of this subtitle, the term 'capital asset' means property held by the taxpayer (*whether or not connected with his trade or business*)" (emphasis supplied). This all-inclusive definition is then followed by five specific exceptions,[6] none of which is claimed to embrace the Bank shares involved here. It is true that these five exceptions—which cover among

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[5] If Section 1211(a) is operative, Section 1212(a) permits a carryback of capital losses for three years, and a carryforward for five years; capital losses thus carried over may be applied against capital gains in such earlier or later years. The amount of a loss from the sale or exchange of property is determined pursuant to Section 1001(a) and (b).

[6] The body of this definition has not been substantially changed since its enactment in 1924. See Revenue Act of 1924, ch. 234, § 208(a), 43 Stat. 453. The latter four exceptions were added subsequently. The first exception, which includes "stock in trade * * * which would properly be included in the inventory of the taxpayer," was slightly amended in 1934 by the addition of the phrase "to customers" and the word "ordinary." Revenue Act of 1934, ch. 277, § 117(b), 48 Stat. 680.

other things inventory, depreciable or real property used in a trade or business, and business accounts and notes receivable—remove the bulk of business-related assets other than stock and securities from the body of the statutory definition. To that extent, these exceptions qualify the statute's parenthetical clause in a specific and limited fashion. But it is clear that these five exceptions establish no general rule removing *all* business-related assets from the statutory definition, since such a rule would strip the parenthetical clause of its meaning. That clause obviously contemplates that *some* property connected with a trade or business can be a capital asset, and the clause provides that such property *is* a capital asset unless it is covered by one of the five specific exceptions. If one looks simply at the text of the statute, therefore, it seems clear that the 661,000 shares of Bank stock sold by petitioner in 1975 were "capital assets," and hence that the resulting loss was a capital loss controlled by the provisions of Section 1211(a).

Petitioner nevertheless contends that the terms of the statute do not control here because of what it calls "the *Corn Products* doctrine" (Pet. 10). Petitioner refers to a series of lower-court decisions that have construed this Court's opinion in *Corn Products Refining Co.* v. *Commissioner,* 350 U.S. 46 (1955), to support the proposition that the characterization of capital stock as a capital asset turns on the extent to which the taxpayer's acquisition of the shares had a "business" rather than an "investment" purpose. We agree with the court of appeals (Pet. App. A10), and disagree with petitioner (Pet. 15-19), on this point. In our view, *Corn Products* does not justify any deviation from the specific terms of Section 1221.

In the *Corn Products* case, the taxpayer was engaged in the business of refining and selling corn products, but it had a disproportionately small storage capacity for raw corn for an operation of its size. To protect itself against

sharp increases in corn prices, the company, when prices appeared favorable at harvest time, would establish a long position in corn futures so as to assure an adequate supply of raw corn at a stable price. It viewed this approach as preferable to making large expenditures for additional storage facilities. The company would take delivery on these futures contracts to the extent it needed more corn for its manufacturing operations, and it would sell off the remainder of the futures in early summer if no corn shortage appeared imminent. If shortages appeared, however, it sold futures only as it bought spot corn for grinding. In 1940, the company netted a profit of $680,000 in corn futures, and in 1942 it netted a loss of $110,000. See 350 U.S. at 48-49. The company claimed that its futures contracts were "capital assets" within the meaning of Section 1221's predecessor, contending that it was acting as a "legitimate capitalist" in its futures transactions. The Commissioner disagreed, and the debate between the parties focused on whether the futures transactions constituted hedging transactions, which for many years had been "regarded as insurance rather than a dealing in capital assets" (350 U.S. at 52).

The court of appeals decided against the taxpayer, affirming a Tax Court decision that had resolved the case on other grounds. 215 F.2d 513 (2d Cir. 1954). The court of appeals' opinion made clear that the basis of its decision was the specific statutory exception for business "inventory" (215 F.2d at 516):

> The tax treatment of hedges, then, is not a "judge-made exception" to [the predecessor of Section 1221]; it is simply a recognition by the courts that property used in hedging transactions comes within the exclusions of the section.
>
> * * * * *
>
> Futures contracts were entered into to stabilize inventory costs and thus protect profit, and whether com-

plete or only partial insurance was thereby obtained is simply a difference in degree, not in kind.

This Court affirmed the court of appeals' decision in *Corn Products*, and there is no justification for viewing this Court's opinion as creating a judge-made exception to the specific definition of "capital asset" enacted by Congress. Rather, we believe that this Court's holding in *Corn Products*, in line with the explicit statement by the court of appeals there, was that the corn futures in the circumstances of that case fell within the "inventory" exception to what is now Section 1221. See 350 U.S. at 53-54. And this reading of *Corn Products* is strongly supported by this Court's subsequent statement in *Malat* v. *Riddell*, 383 U.S. 569, 572 (1966), that "[a] literal reading of [Section 1221] is consistent with [its] legislative purpose." See also *United States* v. *Mississippi Chemical Corp.*, 405 U.S. 298 (1972). Accordingly, we see no justification for reading *Corn Products* as creating an additional "business purpose" exception to the specific terms of Section 1221.

2. We agree with petitioner, however, that several courts of appeals have embraced the notion that there is such a judicial exception to the statutory definition of "capital asset." The source of this line of cases is *Booth Newspapers, Inc.* v. *United States*, 303 F.2d 916 (Ct. Cl. 1962), where the court found that stock in a paper company purchased in order to assure a supply of newsprint in a time of shortage could be treated as a non-capital asset. The court relied on a passage in the *Corn Products* opinion—a passage in which this Court described the operation of Section 1221's predecessor in general terms—as establishing a new judge-made addition to the list of exceptions contained in the statute. See 303 F.2d at 920, citing 350 U.S. at 51-52. In the Court of Claims' view, this nonstatutory exception enables securities to become a non-capital asset if they have been acquired "by a taxpayer as an integral and necessary act in conduct of his business,"

whereas the identical securities would remain a capital asset if "an investment purpose be found to have motivated the [taxpayer's] purchase or holding of [them]" (303 F.2d at 921).

The Court of Claims' theory in *Booth Newspapers* was adopted and applied by the Sixth Circuit in *Steadman* v. *Commissioner*, 424 F.2d 1, 5, cert. denied, 400 U.S. 869 (1970).[7] In that case, capital stock was acquired by a taxpayer in order to gain access to technical staff, and the shares were held to be non-capital assets. More recently, in *Campbell Taggart, Inc.* v. *United States*, 744 F.2d 442 (1984), the Fifth Circuit held that the purchase and sale of certain shares of stock by a holding company in order to preserve its business reputation gave rise, in the particular circumstances of that case, to an ordinary loss. The Fifth Circuit canvassed the line of cases descending from *Booth Newspapers* and reformulated the inquiry for determining when property is a capital asset as "whether the asset was acquired with a business purpose or an investment purpose" (744 F.2d at 457). Other courts have used varying formulations and have reached varied results. See generally 2 B. Bittker, *Federal Taxation of Income, Estates, and Gifts* § 51.10.3, at 51-61 to 51-69 (1981).[8]

As petitioner contends, the decision below conflicts with these decisions. The court of appeals in this case has rejected the idea that there is any judge-made exception to

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[7] Justices Harlan, Stewart and Blackmun dissented from the denial of the Commissioner's petition for a writ of certiorari (400 U.S. 869 (1970)).

[8] The Tax Court, seeking to minimize the uncertain inquiry into corporate motives necessarily engendered by the approach described in the text, has held that securities should be treated as a capital asset as long as the taxpayer had any "substantial investment motive" in acquiring them. See *W.W. Windle Co.* v. *Commissioner*, 65 T.C. 694 (1976), appeal dismissed, 550 F.2d 43 (1st Cir.), cert. denied, 431 U.S. 966 (1977). The Fourth Circuit has reasoned similarly. See *Wright* v. *Commissioner*, 756 F.2d 1039, 1042 (1985).

Section 1221's plain terms, holding that capital stock is a capital asset unless it falls within one of the five specific statutory exceptions. In our view, a decision of this Court is required to resolve the increasing divergence in the courts of appeals with respect to the proper interpretation of the *Corn Products* decision. The tax treatment of dispositions of securities arguably acquired for any non-investment business purpose is an important and recurring issue, and the amounts in controversy characteristically are substantial. Moreover, although the Tax Reform Act of 1986 has eliminated for the future the preferential rate of tax on long-term capital gains (see Pub. L. No. 99-514, §§ 301, 311 (Oct. 22, 1986)), the *Corn Products* issue retains its full significance because the new Act has not altered the limitations on the deductibility of capital losses. See 2 H.R. Conf. Rep. 99-841, 99th Cong., 2d Sess. 105-106 (1986). And it is of course in the context of losses that the question presented here typically arises. Accordingly, we do not oppose the grant of certiorari in this case.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

CHARLES FRIED
Solicitor General

ROGER M. OLSEN
Assistant Attorney General

ERNEST J. BROWN
Attorney

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